

Office of Chief Counsel  
Internal Revenue Service

**memorandum**

CC:LM:MT:DET:POSTF-149561-01  
GEGabriel

date: October 2, 2001

to: Larry Walter, Inventory Technical Advisor

from: Area Counsel  
(Heavy Manufacturing, Construction and Transportation: Edison)

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subject: [REDACTED]  
**Replacement cost for LIFO parts inventory**

This memorandum responds to your request for our legal opinion on the above-referenced taxpayer's use of replacement cost to value its last-in, first-out (LIFO) inventory increments. This memorandum should not be cited as precedent.

**Issue**

Whether [REDACTED] (Taxpayer) can use replacement cost to determine the current-year cost of items making up its LIFO pool for parts.

**Conclusion**

No. The use of replacement cost to determine current-year cost violates § 472(b), Treas. Reg. §§ 1.472-2(b) and 1.472-8(e)(2)(ii); and, consequently, does not clearly reflect income.

**Facts**

Taxpayer is an automobile dealership using the overall accrual method of accounting and the dollar-value LIFO inventory method. Prior to its [REDACTED] taxable year, taxpayer used the first-in, first out (FIFO) inventory method. Taxpayer either valued its inventory at replacement cost based on the last monthly price tape from the manufacturer or used pure cost or market, whichever is lower ("lower of cost or market" or "LCM"). Taxpayer elected to use the LIFO method by filing a Form 970 (Application to Use LIFO inventory Method) for its [REDACTED] taxable year, determining current-year cost based on the actual cost of most recent purchases in accordance with Treas. Reg. § 1.472-8(e)(2)(ii)(a).

In practice, however, taxpayer used replacement cost as current-year cost instead of the actual cost of most recent purchases. Specifically, Taxpayer maintained its inventory of parts based on pricing tapes, updated monthly, from the manufacturer.

### Discussion and Analysis

Section 472(b)(2) provides that taxpayers using the LIFO method must inventory their goods at cost and Treas. Reg. § 1.472-2(b) provides that LIFO inventory must be taken at cost regardless of market value.

Section 1.472-8(e)(2)(ii) permits taxpayers to determine current year cost (a) by reference to the actual cost of the goods most recently purchased or produced; (b) by reference to the actual cost of the goods purchased or produced during the taxable year in the order of acquisition ("earliest acquisitions cost"); (c) by application of an average unit cost equal to the aggregate cost of all the goods purchased or produced throughout the taxable year divided by the total number of units so purchased or produced; or (d) pursuant to any other proper method which, in the opinion of the Commissioner clearly reflects income.

Section 471 provides inventories must be taken on such basis as the Secretary may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting income. Section 1.471-3(d) provides that in any industry in which the usual rules for computation of cost or production are inapplicable, costs may be approximated upon such basis as may be reasonable and in conformity with established trade practice within a particular industry.

In *Mountain State Ford Truck Sales, Inc. v. Commissioner*, 112 T.C. 58 (1999), the Tax Court held the use of replacement cost when determining current-year cost violates § 472(b)(2), Treas. Reg. § 1.472-2(b) and Treas. Reg. § 1.472-8(e)(2)(ii) and, consequently, does not clearly reflect income. In *Mountain State Ford* the Court noted that the definition of the term cost in Treas. Reg. § 1.471-3 is longstanding, dating back to 1936 (Regs. 94, art. 22(c)-3(1936)).

In addition, in *Mountain State Ford* the court held taxpayer was bound by its election to use the "most recent purchases cost" method of determining current year cost, notwithstanding the fact Treas. Reg. § 1.472-8(e)(2)(ii)(D) permits taxpayers to determine current year cost using any other method the Commissioner determines clearly reflects income. Moreover, the Court held that even an "other" method under Treas. Reg. § 1.472-8(e)(2)(ii)(D) must determine current-year cost on the basis of, or by reference to, actual cost, or in certain cases a reasonable approximation of cost.

Section 1.471-3(d)(4), provides any industry in which the usual rules for production are inapplicable, cost may be approximated upon such basis as may be reasonable and in conformity with established trade practice in a particular industry. However, a method based on a reasonable approximation of cost must be a method

sanction by the service such as the retail LIFO method set forth in Treas. Reg. § 1.472-1(k).

Should you have any questions concerning this matter, please contact the undersigned attorney at (313) 237-6424. This advice is subject to National Office Review and should not be relied upon or disseminated for a period of 30 days or upon notification of this office. This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

We note this issue is presently under study and the Service is exploring various alternatives that would permit taxpayers to approximate actual cost. Some of these alternatives are based on replacement cost.

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